

ONYX
PÉTROLEUM
EXPLORATION
COMPANY
LTD.

1985
ANNUAL
REPORT

CORPORATE PROFILE



Onyx is an active oil and gas exploration company with production from established reserves in various areas of Alberta and British Columbia.

The Company was incorporated as a public company under the Companies Act of Alberta on November 10, 1976, as Rangeco Oil & Gas Ltd. The name was changed to Onyx Petroleum Exploration Company Ltd. on November 30, 1979, and on May 26, 1983, the Company was continued under the Business Corporations Act (Alberta).

CORPORATE INFORMATION

Officers and Senior Personnel

D. G. FLANAGAN
President

A. J. SIMUS
Executive Vice President

L. L. HANSEN
Vice President — Finance

M. G. WEBB
Vice President — Exploration

R. D. S. DOUGLAS
Senior Engineer

C. W. HICKS
Chief Accountant

Head Office

2000 Daon Building
444 - 5th Avenue S.W.
Calgary, Alberta
T2P 2T8

Corporate Registrar and Transfer Agents

The Canada Trust Company

Board of Directors

R. J. ENGBLOOM
(Calgary, Alberta)
Partner, MacKimmie Matthews

D. G. FLANAGAN
(Calgary, Alberta)
President of the Company

J. M. HALLWARD
(Montreal, Quebec)
Self Employed

H. G. MacNEILL
(Toronto, Ontario)
President and Chief Executive Officer
Jannock Limited

V. R. B. NORDHEIMER
(Calgary, Alberta)
Retired Business Executive

A. J. SIMUS
(Calgary, Alberta)
Executive Vice President of the Company

L. WAISBERG
(Toronto, Ontario)
Partner, Goodman & Goodman

Bankers

Bank of Montreal
Calgary, Alberta

Auditors

Thorne Riddell
Calgary, Alberta

Solicitors

MacKimmie Matthews
Calgary, Alberta

Share Listing

The Toronto Stock Exchange
The Alberta Stock Exchange
The Montreal Exchange

HIGHLIGHTS

Financial	1984	1985
Revenue	\$7,325,830	\$7,641,290
Cash Flow	4,009,664	4,889,312
Net Earnings	1,239,110	1,286,341
Capital Expenditures	6,480,769	6,429,707
Bank Loan	4,100,000	5,700,000
11% Convertible Debentures	7,400,000	7,400,000
Common Shares Outstanding	3,660,649	3,740,149

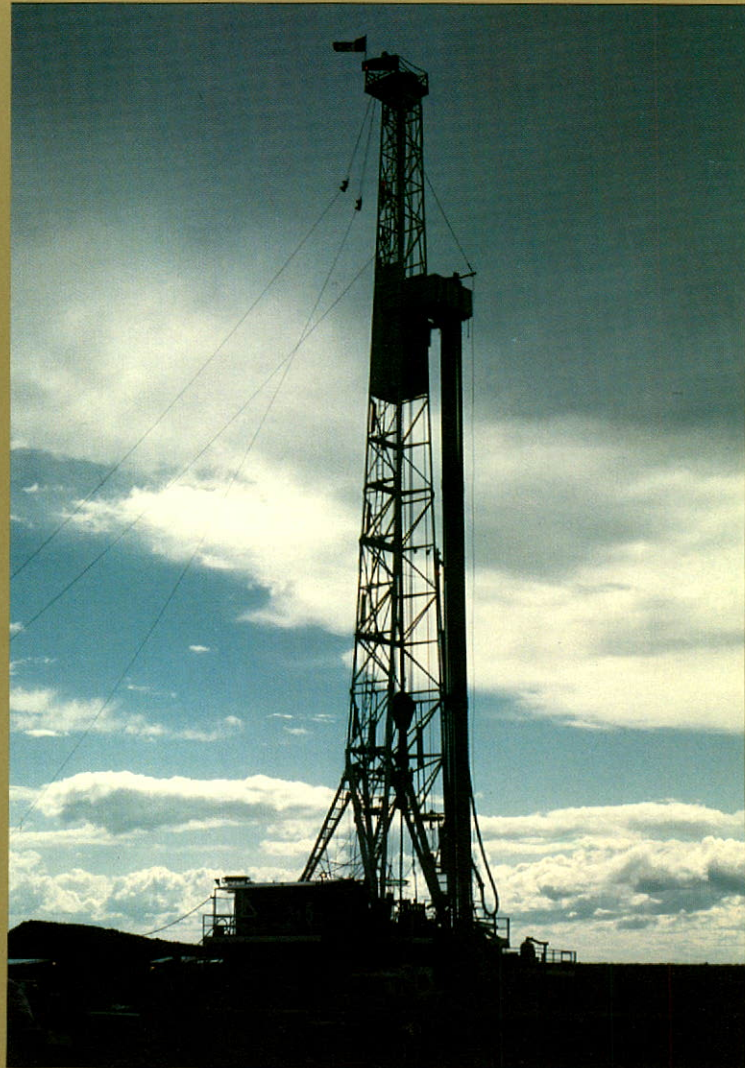
Operational

Gross Daily Production		
Crude Oil and Natural Gas		
Liquids (barrels)	518	525
Natural Gas (thousands of cubic feet — Mcf)	1,684	1,987

Market Data

The Common Shares of the Company are listed on the Toronto, Montreal, and Alberta Stock Exchanges. The high and low sales prices for the Common Shares on The Toronto Stock Exchange for each quarter of the years 1984 and 1985, are tabulated below:

	1984		1985	
	High	Low	High	Low
First Quarter	10¼	8⅛	9	6⅞
Second Quarter	10¾	8	8¾	7¾
Third Quarter	9	7⅛	8⅛	6⅞
Fourth Quarter	9¼	7½	9	5



APR 9 1986
McGILL UNIVERSITY

PRESIDENT'S REPORT



The year 1985 has produced mixed results for the industry in general and Onyx in particular. Fiscal changes by both the provincial and federal governments created an environment for the oil industry as good or better than any country in the world. However, offsetting the gains created by the change in fiscal terms and increased production was a decline in prices for both oil and gas. The oil prices we received in 1984 and the beginning of 1985 for our "new" oil were artificially high relative to the world oil price. With the elimination of the National Energy Policy in 1985 prices paid for "new" oil were immediately lowered to the world prices which also started to decline throughout the year. Subsequent to the year end crude oil prices have decreased to about half of our 1985 prices, and the future price level is very uncertain at this time.

Financial

In spite of the reduced prices our revenue increased 4% to \$7,641,290 compared to 1984, and cash flow increased 22% to \$4,889,312. Net earnings increased 4% to \$1,286,341 compared to 1984. As a result of our corporate acquisition in early 1986 production will be substantially higher than in 1985, however, with oil prices falling it is too early to predict with any degree of certainty what the financial results will be in the current year.

Acquisition of Gallita Oils Limited

On January 29, 1986 we announced the acquisition of Gallita Oils Limited, a private company with oil and gas production in Alberta. Gallita's assets included approximately 600,000 bbls of oil, almost all of which is proven producing, 1.3 Bcf of producing gas reserves, and approximately \$5 million of working capital. The acquisition was closed on February 25, 1986 for a total consideration of approximately \$10.5 million with production and interest accruing to Onyx's account as of January 1, 1986. Production from Gallita's properties is expected to add significantly to the Company's production revenues in 1986 and future years.

1986

The year 1986 will obviously be a year of uncertainty. With the combination of deregulation of Canadian oil pricing and marketing coincident with the apparent breakdown of the OPEC cartel and stubbornness of Britain and Norway to cut back on their production rates, we now have an oil price less than 50% of what it was last year. While the margin of surplus oil relative to the total production is really quite small (4-5%) there is no early indication of who is going to cut back their production to

balance the supply-demand equation. For the time being we have to assume these price levels will exist for some time and we have therefore taken steps to reduce our expenditures to keep them in line with our revenues. The capital budget has been decreased by approximately \$3 million to \$3.4 million. Most of the expenditures for drilling will occur during the first quarter before PIP grants expire, with the balance of the capital budget to be directed to a waterflood project at Keho and some development drilling where risks are low and early cash flow can be anticipated. Operating and administrative expenses were reduced to a minimum in the first quarter of 1986 and this area will be kept under close review throughout the year.

We are satisfied the Gallita acquisition will be an important part of our 1986 operations even with the lower than anticipated revenues. We also expect to maximize the tax shelter benefits of the Onyx tax pools through a business combination of Gallita's operations.

Crude Oil Marketing/Regulations

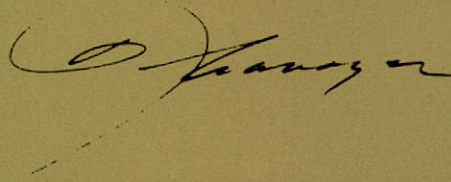
Canadian oil producers are not getting a fair price for their oil. During the NEP days "old" oil which represented some 75-80% of Alberta production received prices substantially lower than the world price. Now with deregulated oil prices producers are being paid at rates based on spot prices which are considerably lower than West Texas intermediate contract prices. When the reverse circumstances existed we were paid at the contract rates. Security of supply to both eastern Canada and the U.S. should be a factor in pricing, but with a buying cartel made up of four to five multinationals and Petro-Canada offering low "take it or leave it" prices the alternative is to shut in production which is not very practical. Why does it seem refiners only have inventory oil when prices go down and very little when crude prices go up? Why do the pump prices take so long to reflect the drastic cut in crude prices? Somebody is making some very large spreads, and it's not the producers. In the February 17, 1986 issue of the Oil & Gas Journal a spokesman from a major crude buyer is reported as saying, "We buy West Texas intermediate. On numerous occasions when we're not running it or trading it for another crude, you actually sell it. THEN YOU TURN AROUND AND BUY CANADIAN CRUDE CHEAPER. Even figuring in the yield loss on those deals, you can make as much as \$3/bbl." (\$4 Canadian). We believe that for industry to be profitable and to be able to generate sufficient funds for

reinvestment, the two levels of government should create an environment, by regulation if necessary, to ensure that producers and governments, from their royalty oil, receive fair value for their production.

Employees

We would like to extend our appreciation to the employees for their contribution over the past year. We only have 12 full time employees and it will be a challenge for them to adjust to the new circumstances which exist in our industry now and in the future. In the interests of the shareholders, particularly those who have been involved from the beginning, we feel comfortable that these challenges will be met and that Onyx will continue to grow and prosper in the years ahead.

Respectfully submitted,



Dennis G. Flanagan
President

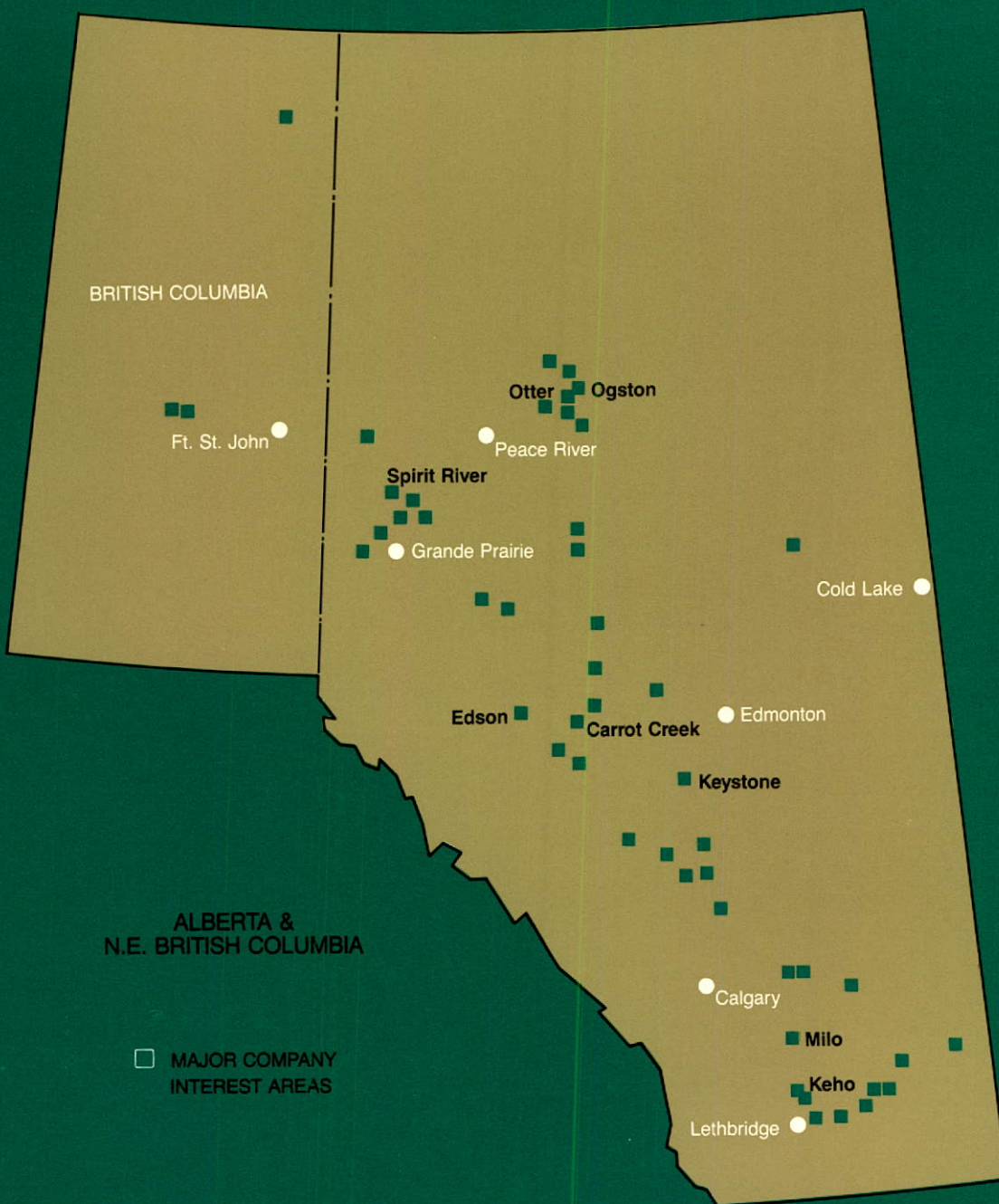
March 26, 1986

EXPLORATION AND DEVELOPMENT

Exploration programs produced mixed results in 1985. During the year Onyx evaluated large tracts of exploratory lands from Keho in the south to Ogston in the north. Efforts were focused on specific areas with large reserves potential and enabled the Company to diversify into areas of year round activity. As a result of these efforts, the Company is now better diversified than ever before and can focus its attention on short term cash flow generating prospects. It is also pursuing medium term objectives pending the return of a healthier natural gas sector of the industry.

During 1985, major exploration and development programs were undertaken at Keho, Grande Prairie, Driftpile and the general Evi Lake to Ogston area. These were fueled by attractive government incentives on exploratory programs and land expirations in the north.

Results of the four programs were disappointing for the short term but set up an active development and exploitation program for the spring of 1986 which, coupled with an improvement in price, will assure long term reserves and revenue growth for the Company.



Diversification of Onyx lands into areas of relatively shallow, year round drilling continued through 1985. Significant land acquisitions were made at Milo, Iron Springs and Purple Springs. The recent acquisition of Gallita Oils Limited also provides us with a substantial production base in the Grand Forks area. In these times of extreme price pressure, we expect to concentrate our programs in and around these small but prolific shallow oil producing reservoirs.

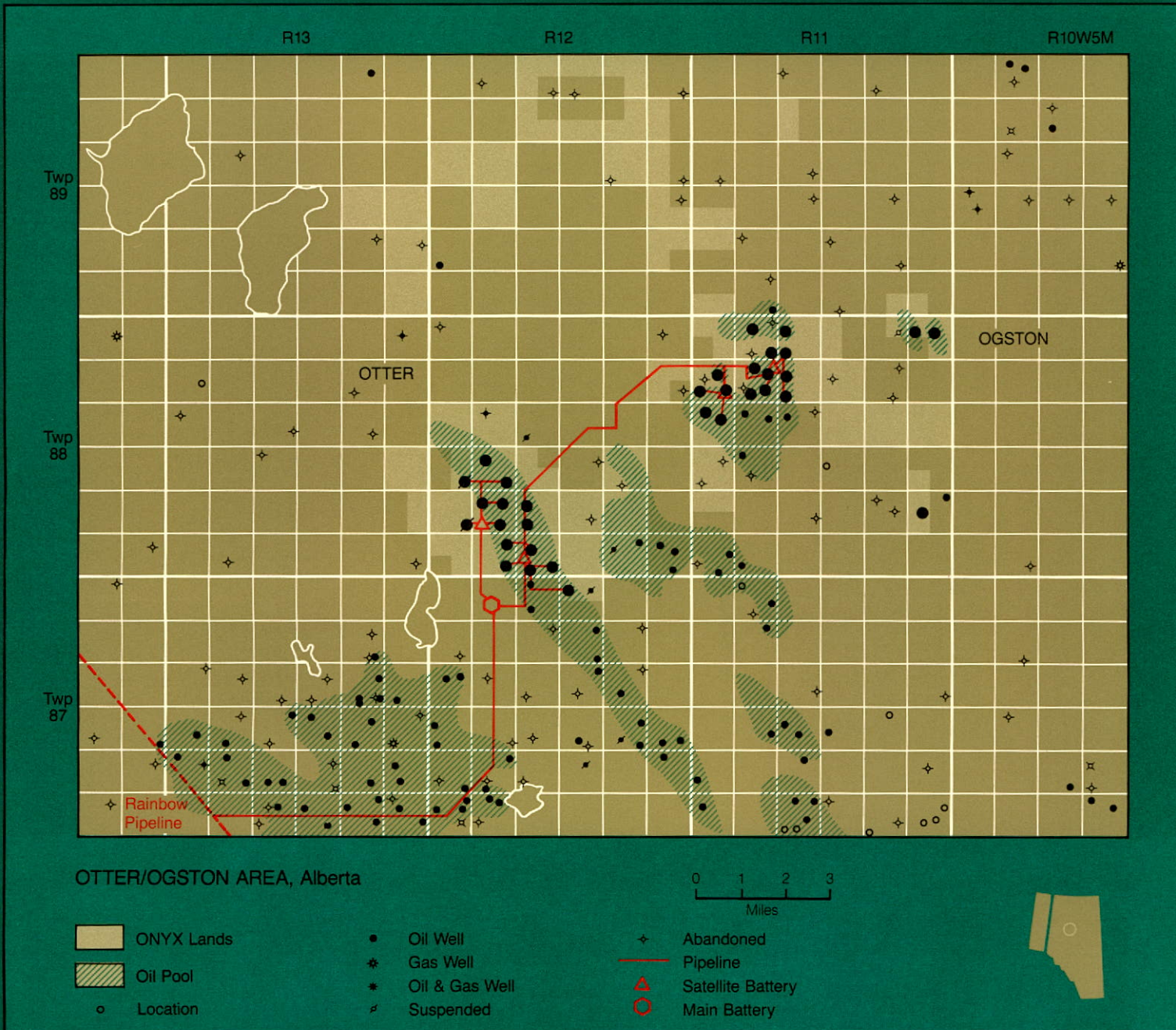
In addition, the Company has selectively purchased lands in gas prone areas in order to be prepared for an anticipated recovery of the natural gas market towards the end of the decade.

Otter — Ogston

In the Otter-Ogston area, most of the Company's exploration acreage has been evaluated and attention is now being focused on lower risk development projects that can add significantly to our reserves.

At Otter East, there have been recent Granite Wash discoveries on lands immediately offsetting acreage in which Onyx holds a varying interest ranging from 18.75% to 37.5%. Onyx plans to drill at least two wells on this acreage in 1986.

At Ogston, six Granite Wash oilwells were drilled in 1985. Additional seismic has been acquired and processed to detail potential drillsites and further development drilling will be undertaken both north and southwest of the pool.



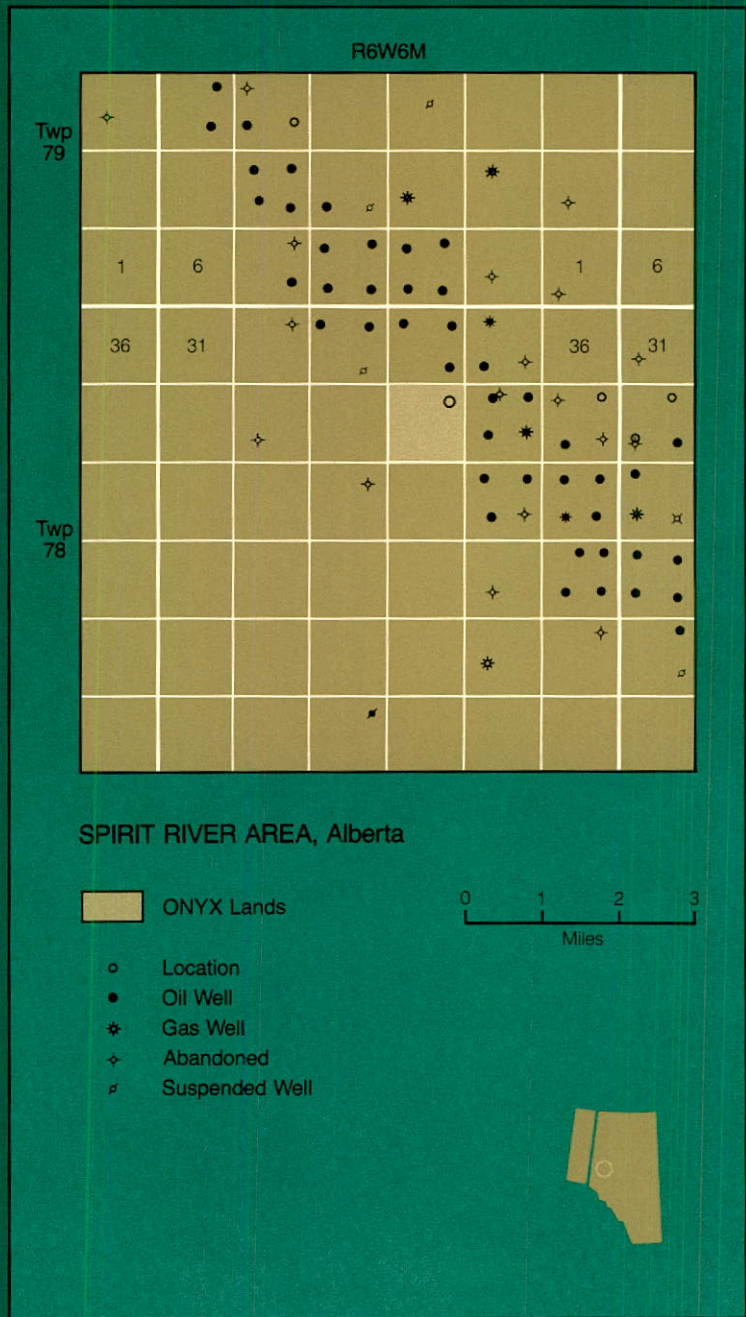
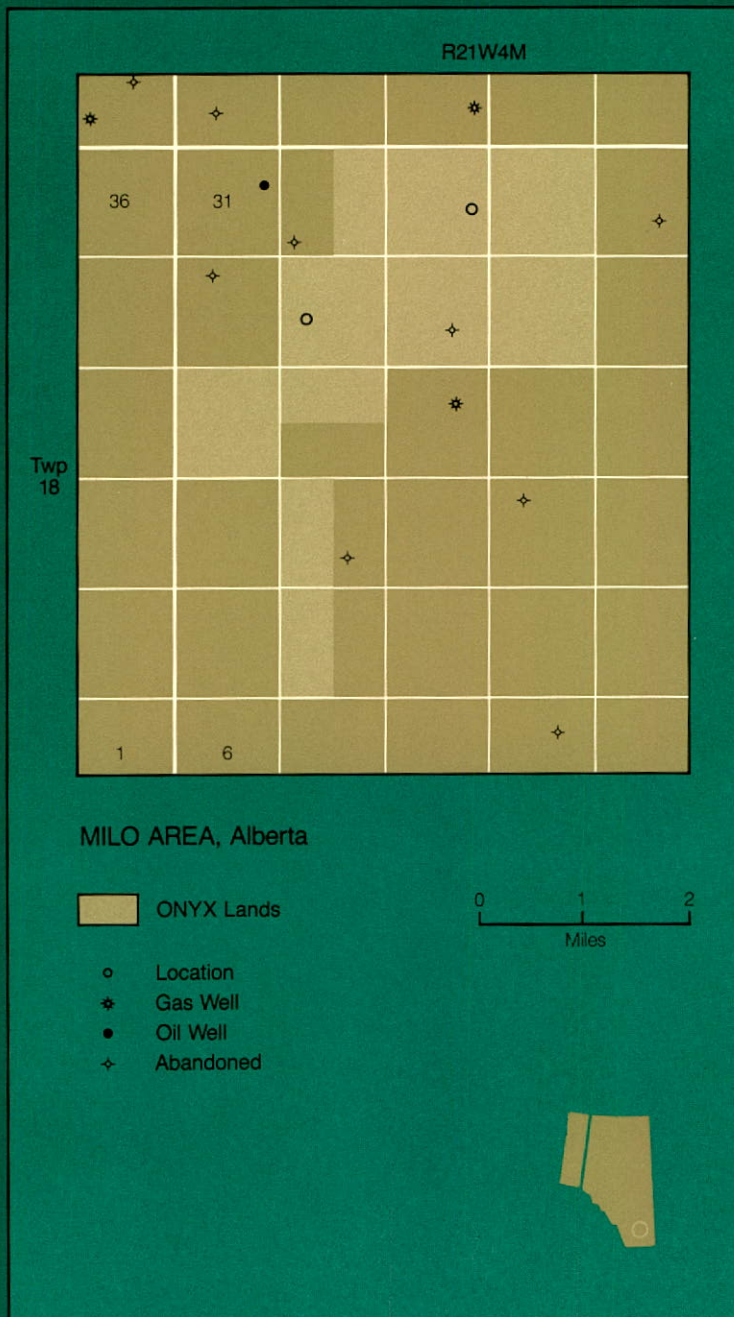
Milo

At Milo, approximately 60 miles southeast of Calgary, Onyx has acquired interests ranging from 20%-35% in 5,120 gross acres. The acreage was acquired as part of the Company's plans to diversify into southern Alberta and two prospects have been developed for further evaluation in 1986.

This area has both oil and gas potential with prospects in the Bow Island, Glauconite, Ostracod and Basal Quartz sandstones.

Spirit River

At Spirit River, located approximately 45 miles north of Grande Prairie, Onyx has a 12.5% interest in 640 acres bordering an active drilling area. Several oil wells capable of producing 30 to 75 barrels of light crude oil per day have been drilled on acreage immediately offsetting our lands. Onyx plans to drill a test well in 1986 to evaluate two potential productive zones.

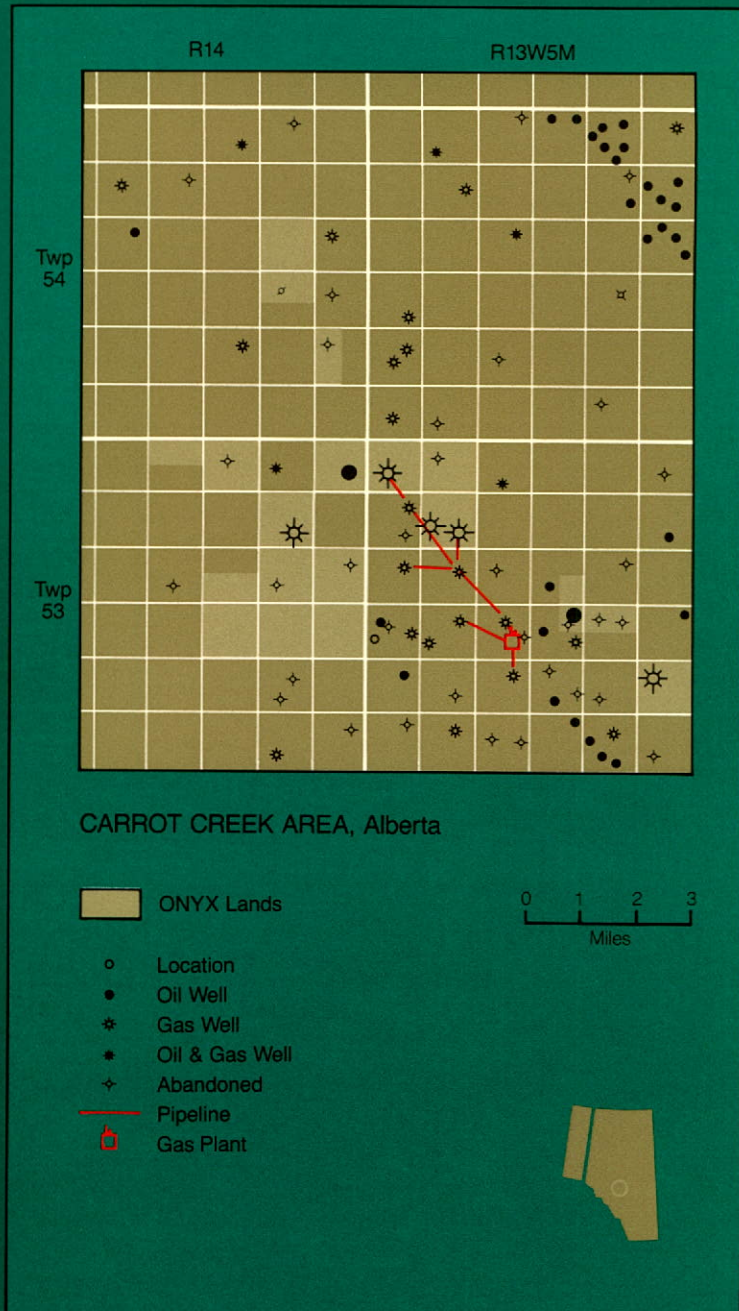
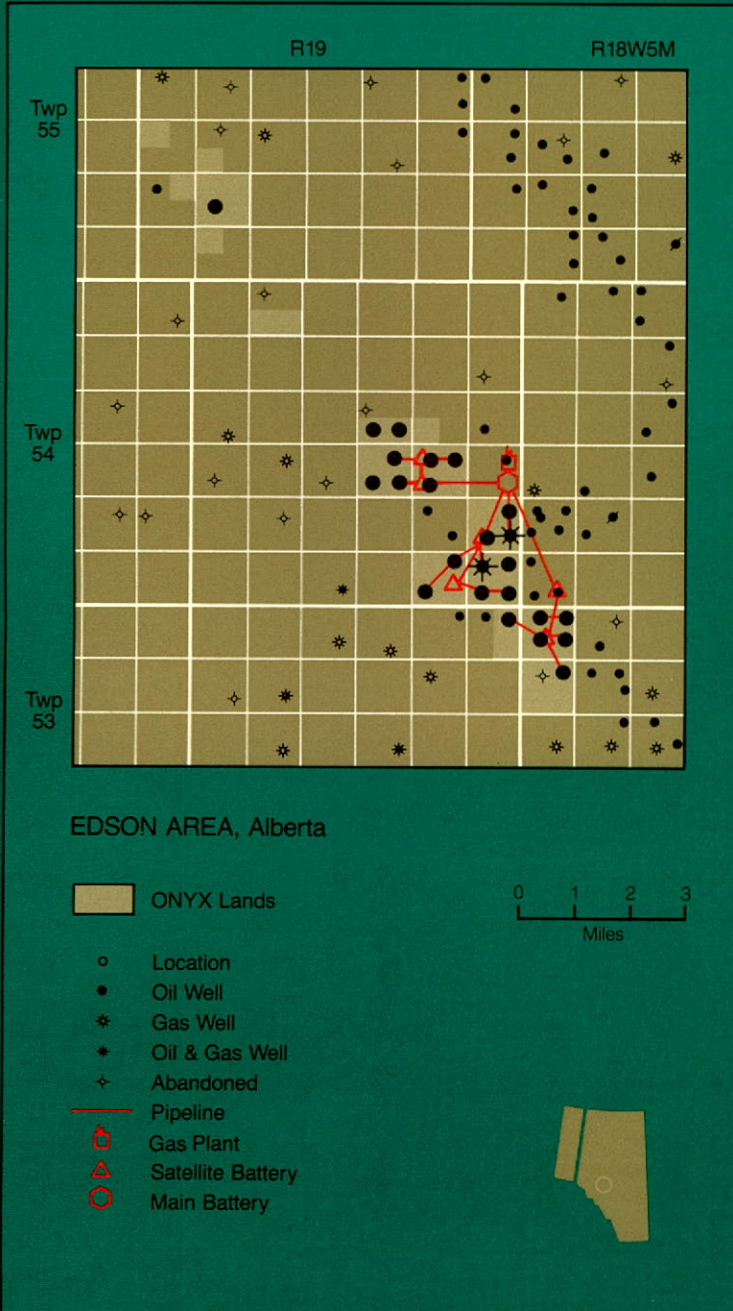


Edson

Two wells were drilled on Company lands during 1985, both of which were completed as Cardium oil producers. Further development at Edson North will depend upon improved economics. The Company owned gas plant was able to process all gas required to meet contracts with some excess capacity being utilized to process other operators' production.

Carrot Creek

At Carrot Creek, Onyx has an interest in six wells which produce gas, condensate, and oil from the Basal Quartz and Cardium sandstone formations. Onyx acquired additional acreage in this area in 1985, but plans for further drilling will depend upon the Company obtaining access to processing facilities as well as the relative strength of existing gas markets. Oil wells in the Cardium conglomerate in the immediate Carrot Creek area have tested at rates of between 30 and 1,300 barrels of oil per day.

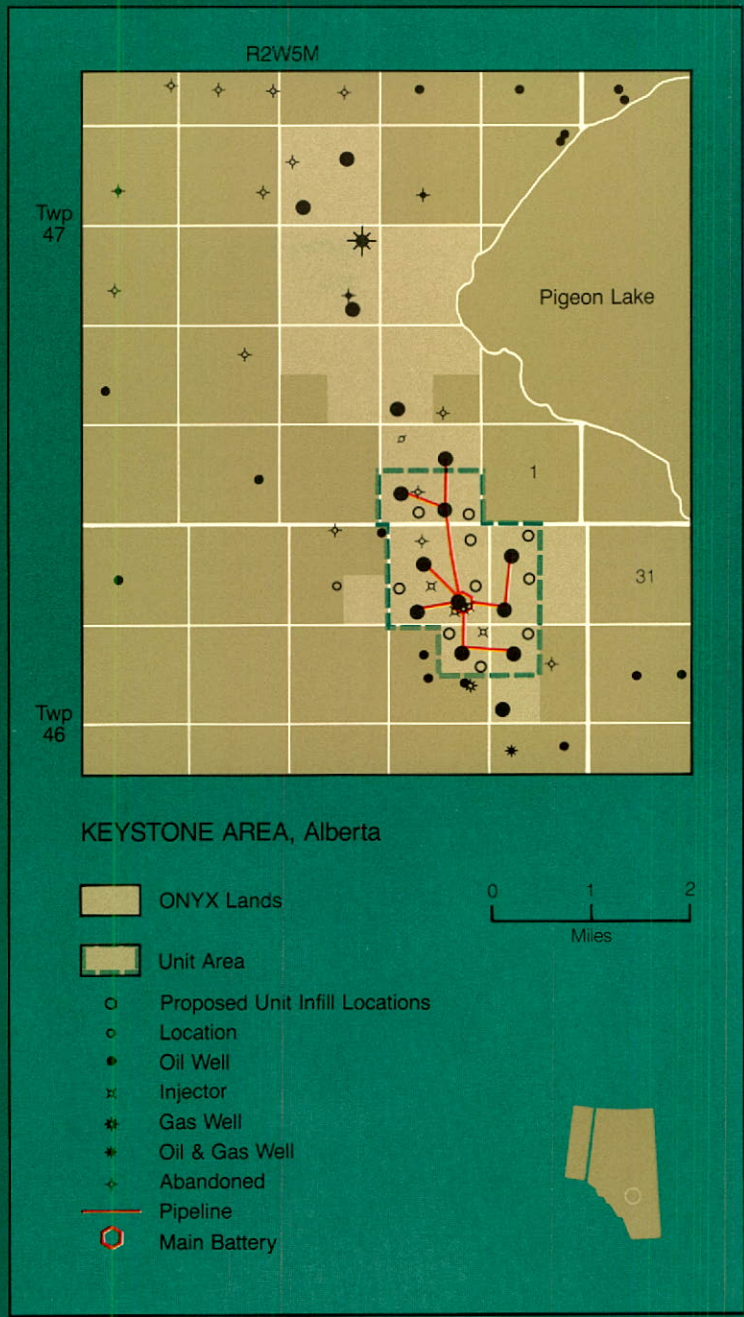
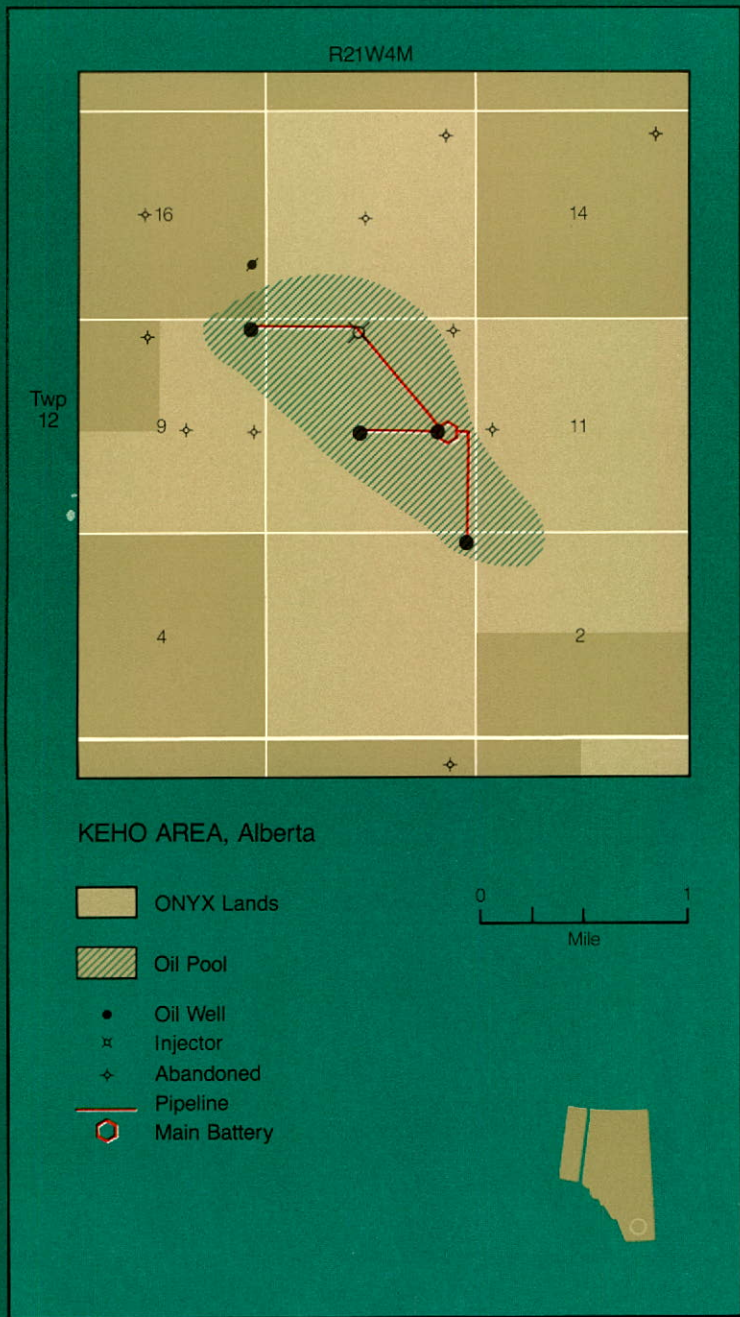


Keho

Delineation drilling around the original discovery well has established the limits of the Keho pool and allowed for the design of a waterflood program. Approval has been granted from the Energy Resources Conservation Board for enhanced recovery by waterflooding and it is expected that water injection will be underway by June, 1986. Construction of flow lines, injection facilities and tank battery should commence soon after spring break-up. Recoverable reserves and production will show improvements later in 1986.

Keystone

At Keystone, in central Alberta, Onyx has a 13.49% working interest in unitized lands which contain 10 producing oil wells and 2 water injection wells. The participants in the unit are currently evaluating an infill drilling program for 1986 that may involve the drilling of an additional five to ten wells. In addition to the planned drilling program, the unitized field is expected to be expanded over a larger area and will include a third producing horizon.



LAND

During 1985, Onyx participated in the acquisition of Crown, Freehold and Natural Gas Leases and Licenses to enlarge the base of exploration acreage needed for future growth and development. A total of 27,106 gross acres (13,442 net acres) were acquired at a net cost to Onyx of \$963,770.

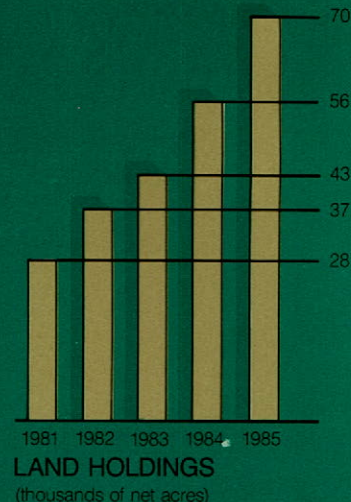
All of the newly acquired lands are in Alberta and the major parcels are located at Carrot Creek, Grande Prairie, Keho and Milo.

Pending a return to more normal product pricing, Onyx will continue to expand its land holdings in western Canada. Following is a comparative summary of the Company's land holdings for the years ending December 31, 1984 and 1985.

DRILLING ACTIVITY

Onyx participated in the drilling of 42 wells in 1985, of which nine were operated by the Company. The Company also farmed out seven wells during the year. The table below details the Company's drilling statistics for 1985:

Land Holdings	1984		1985	
	Acres		Acres	
	Gross	Net	Gross	Net
Alberta	210,752	51,734	227,335	65,375
British Columbia	29,946	4,468	30,608	4,411
Saskatchewan	—	—	1,520	507
Total Land:	240,698	56,202	259,463	70,293



Drilling Activity

Exploratory Wells

Gross Wells				Net Wells			
Oil	Gas	Dry	Total	Oil	Gas	Dry	Total
6	2	13	21	1.46	.65	4.07	6.18

Development Wells

Gross Wells				Net Wells			
Oil	Gas	Dry	Total	Oil	Gas	Dry	Total
11	1	8	20	2.43	.25	2.19	4.87

Farmout Wells

Gross Wells				Net Wells			
Oil	Gas	Dry	Total	Oil	Gas	Dry	Total
2	0	5	7	—	—	—	—

Total Gross Wells - 49
(Includes 1 service well Net .40)
Total Net Wells - 11.45

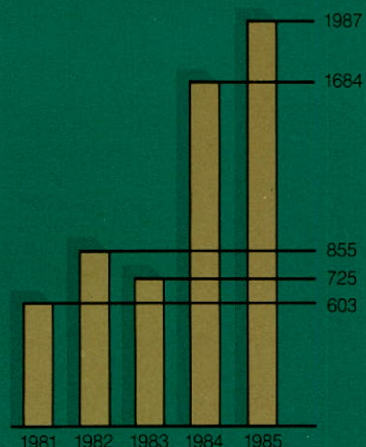
PRODUCTION

The Company's share of oil and natural gas liquids production in 1985 was 191,661 barrels, for an average of 525 barrels per day. This represents a slight increase over the 518 barrels per day produced in 1984. Natural gas sales of 725,288 Mcf in 1985 averaged 1,987 Mcf/d, for an increase of 18% over the 1984 sales of 1,684 Mcf/d.

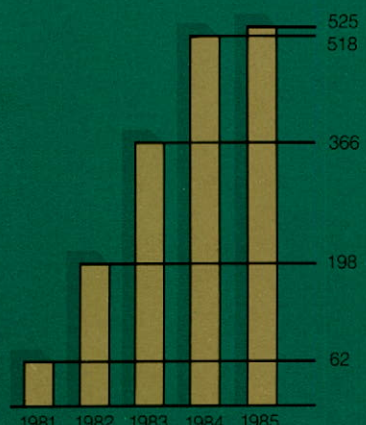
Oil production increases resulting from 1985 drilling programs were largely offset by prorationing, which resulted in production being shut in at various times throughout the year, and by a productivity decline at the Edson field. Oil production

from the Edson field appears to have stabilized and should remain steady throughout 1986. Gas production from Edson increased during 1985.

Onyx has received approval from the Energy Resources Conservation Board to commence a waterflood enhanced recovery program in the Bow Island oil pool at Keho in southern Alberta. The injection of water will support reservoir pressure and thereby improve production and recoverable reserves. The program is scheduled to commence in June and is expected to result in increased production volumes by late fall.



PRODUCTION OF NATURAL GAS
(thousand cubic feet per day)



PRODUCTION OF CRUDE OIL & LIQUIDS
(barrels per day)



RESERVES

In central Alberta, Onyx is participating in an evaluation of oil production from the Belly River zone with a view to expanding the Keystone unit. An expansion would add additional land and reservoir to the unit and would increase both the recoverable reserves and production.

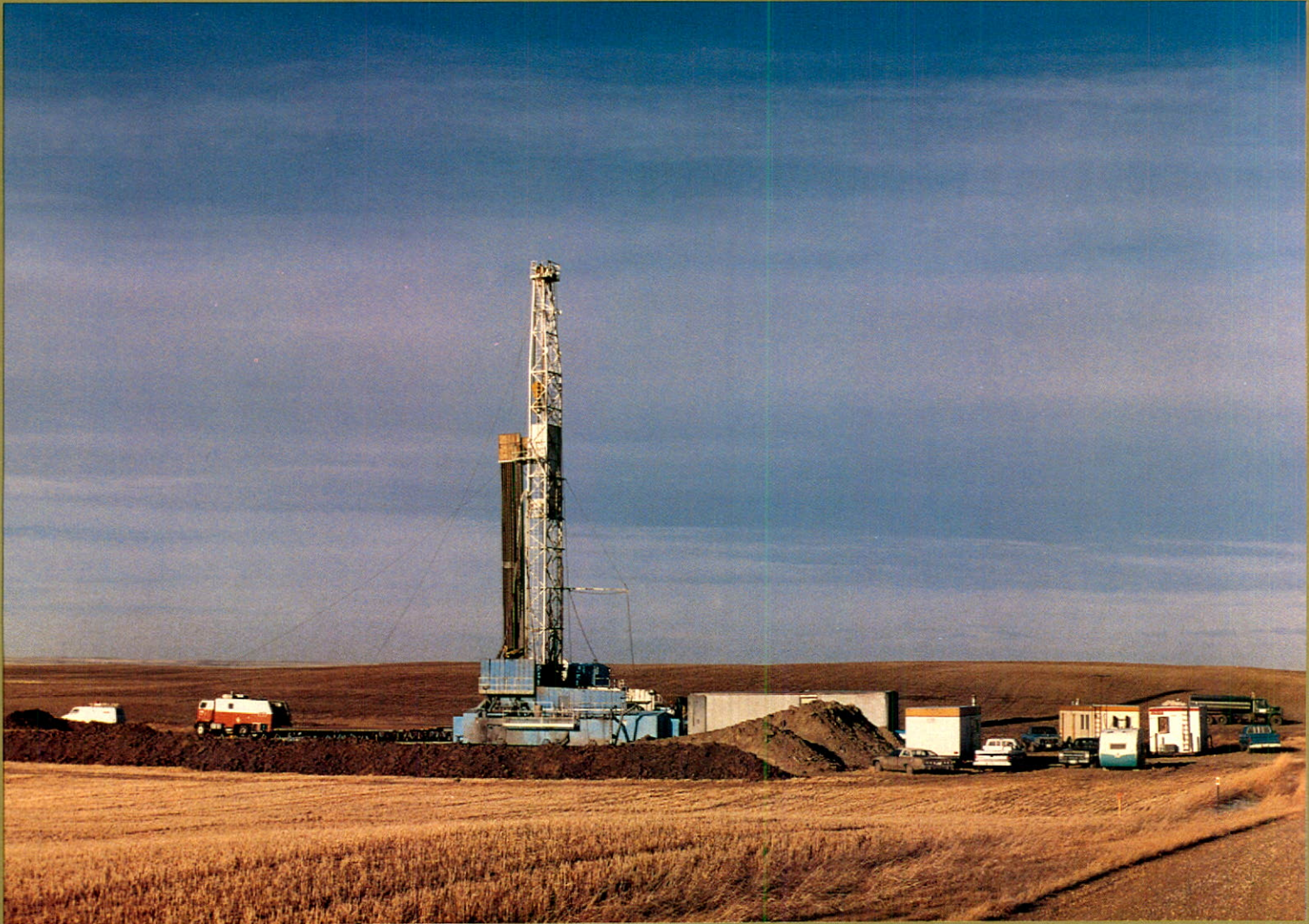
The addition of the Gallita properties that were acquired effective January 1, 1986, will provide a substantial increase in Onyx's daily oil production. This production is from high quality reservoirs and will contribute to a solid production base.

The Company's oil and natural gas reserves as at December 31, 1985 were evaluated by D & S Petroleum Consulting Group Ltd. Effective January 1, 1986, Onyx Petroleum Exploration Company Ltd. acquired Gallita Oils Limited, a private Alberta company. Gallita's reserves of oil and natural gas as at January 1, 1986 were evaluated by McDaniel & Associates Consultants Ltd.

The following table summarizes the reserves of both companies and shows a consolidation of total reserves as evaluated by the independent consultants.

Reserves	Onyx (85/12/31)	Gallita (86/01/01)	Consolidated
Proved Oil + NGL (bbls)	1,800,894	494,400	2,295,294
Gas (Bcf)	16.34	1.00	17.34
Proved plus Probable			
Oil + NGL (bbls)	2,187,703	600,700	2,788,403
Gas (Bcf)	20.08	1.28	21.36





During 1985 Onyx was able to withstand a drop in product prices and still report record operating results due to an increase in crude oil and natural gas production and lower borrowing costs. Increased cash flow combined with a \$1.6 million bank loan enabled the Company to finance an active \$6.4 million capital expenditure program over the year.

Revenue from the sale of crude oil, natural gas and natural gas liquids, after the deduction of royalties and mineral taxes, amounted to \$7,097,863 in 1985, for a nominal increase above the \$7,025,259 reported in 1984. Cash flow from operations at \$4,889,312 increased 22% over the \$4,009,664 reported last year.

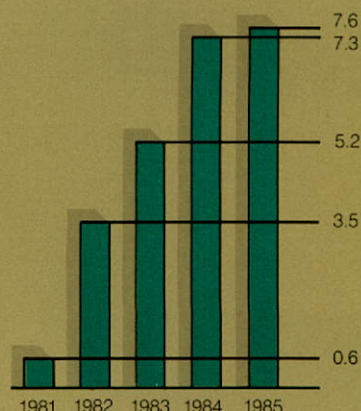
Net earnings in 1985 were a record \$1,286,341 compared to \$1,239,110 in 1984.

Increased revenues resulted from higher crude oil and liquids production in the Otter, Keho and Keystone areas of Alberta. Revenue from the production of natural gas increased during the year at Carrot Creek, Edson and Majeau Lake, all of which are in Alberta.

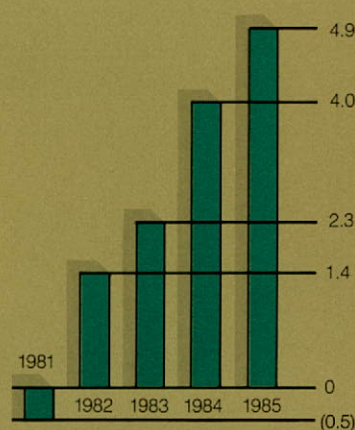
Management has made a concerted effort to control the Company's variable expenses, and for 1985 total expenses of \$5,654,949 were up a nominal 6% from the \$5,356,720 reported the previous year. Included in the total are operating

expenses of \$949,205 which reflect an approximate 23% increase over 1984, due to a combination of higher than normal start up costs in several new areas and lower oil production volumes, particularly in the Edson and Mud Lake areas. General and administrative expenses of \$727,827 were up 8% from 1984 reflecting a nominal increase in product and service prices and overall corporate activity. Interest expense declined from \$1,891,913 in 1984 to \$1,402,389 in 1985. A substantial reduction in bank loans in the latter part of 1984, combined with slightly lower interest rates in 1985, accounts for the approximate 26% decline in interest expense in 1985. The Company follows the full cost method of accounting and in 1985 depletion and depreciation expenses of \$2,575,528 were approximately 28% higher than the \$2,015,984 reported for 1984. Working capital at December 31, 1985 amounted to \$1,013,501 as compared to \$800,886 at the end of 1984.

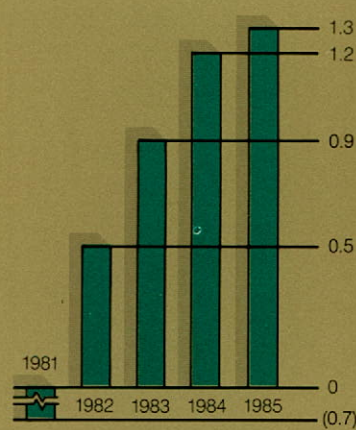
Early in 1986, Onyx acquired all of the issued and outstanding shares of Gallita Oils Limited for a cash consideration of \$10.5 million. The acquisition was financed through a major Canadian bank and, subsequent to the closing, bank loans were reduced by \$5 million from proceeds of a dividend paid by Gallita to Onyx.



REVENUE
(millions of dollars)



CASH FLOW
(millions of dollars)

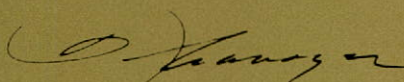


NET INCOME
(millions of dollars)

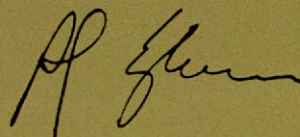
BALANCE SHEET as at December 31, 1985

Assets	1984	1985
CURRENT ASSETS		
Cash	\$ 88,285	\$ 85,694
Accounts receivable	1,685,519	1,767,362
Government incentive grants receivable	519,690	934,052
	<u>2,293,494</u>	<u>2,787,108</u>
FIXED ASSETS		
Petroleum and natural gas properties including exploration, development and equipment thereon, at cost	37,588,343	44,017,021
Accumulated depletion and depreciation	4,231,968	6,806,467
	<u>33,356,375</u>	<u>37,210,554</u>
OTHER ASSETS (note 2)	380,219	664,649
	<u>\$36,030,088</u>	<u>\$40,662,311</u>
Liabilities		
CURRENT LIABILITIES		
Accounts payable	1,492,608	\$ 1,773,607
BANK PRODUCTION LOAN (note 3)	4,100,000	5,700,000
11% CONVERTIBLE DEBENTURES (note 4)	7,400,000	7,400,000
GAS PRODUCTION PREPAYMENTS	210,174	210,174
DEFERRED TAXES	1,147,400	2,150,273
	<u>14,350,182</u>	<u>17,234,054</u>
Shareholders' Equity		
CAPITAL STOCK (note 5)		
Issued		
5,185 Restricted Return Shares (1984 — 5,313)	531,300	518,500
3,740,149 Common Shares (1984 — 3,660,649)	18,496,288	18,962,138
	<u>19,027,588</u>	<u>19,480,638</u>
CONTRIBUTED SURPLUS	673,134	682,094
RETAINED EARNINGS	1,979,184	3,265,525
	<u>21,679,906</u>	<u>23,428,257</u>
	<u>\$36,030,088</u>	<u>\$40,662,311</u>

Approved by the Board



Director



Director

STATEMENT OF EARNINGS Year Ended December 31, 1985

	1984	1985
REVENUE		
Oil and gas sales, net of royalties	\$7,025,259	\$7,097,863
Alberta Royalty Tax Credit	870,534	846,300
Petroleum and Gas Revenue Tax		
Deferred	—	(302,873)
Current	(569,963)	—
	7,325,830	7,641,290
EXPENSES		
Operating	774,583	949,205
General and administrative	674,240	727,827
Interest on long term debt	1,891,913	1,402,389
Depletion and depreciation	2,015,984	2,575,528
	5,356,720	5,654,949
Earnings before income taxes	1,969,110	1,986,341
DEFERRED INCOME TAXES	730,000	700,000
NET EARNINGS	\$1,239,110	\$1,286,341
NET EARNINGS PER COMMON SHARE	\$0.42	\$0.35
Weighted average number of Common Shares outstanding	2,970,967	3,669,422

STATEMENT OF RETAINED EARNINGS Year Ended December 31, 1985

	1984	1985
RETAINED EARNINGS AT BEGINNING OF YEAR	\$ 740,074	\$1,979,184
Net earnings	1,239,110	1,286,341
RETAINED EARNINGS AT END OF YEAR	\$1,979,184	\$3,265,525

STATEMENT OF CHANGES IN FINANCIAL POSITION Year Ended December 31, 1985

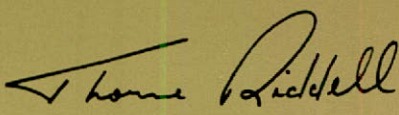
	1984	1985
WORKING CAPITAL DERIVED FROM		
Operations		
Net earnings	\$ 1,239,110	\$1,286,341
Add items not requiring working capital		
Depletion and depreciation	2,015,984	2,575,528
Deferred income taxes	730,000	700,000
Deferred Petroleum and Gas Revenue Tax	—	302,873
Amortization of deferred financing charges	24,570	24,570
	4,009,664	4,889,312
Bank production loan	2,525,000	1,600,000
Issue of Common Shares	5,708,529	465,850
	12,243,193	6,955,162
WORKING CAPITAL APPLIED TO		
Fixed assets	6,480,769	6,429,707
Other assets	179,560	309,000
Bank production loan	5,425,000	—
Purchase of Restricted Return Shares	5,130	3,840
	12,090,459	6,742,547
INCREASE IN WORKING CAPITAL	152,734	212,615
Working capital at beginning of year	648,152	800,886
WORKING CAPITAL AT END OF YEAR	\$ 800,886	\$1,013,501

AUDITORS' REPORT

To the Shareholders of
Onyx Petroleum Exploration Company Ltd.

We have examined the balance sheet of Onyx Petroleum Exploration Company Ltd. as at December 31, 1985 and the statements of earnings, retained earnings and changes in financial position for the year then ended. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests and other procedures as we considered necessary in the circumstances.

In our opinion, these financial statements present fairly the financial position of the Company as at December 31, 1985 and the results of its operations and the changes in its financial position for the year then ended in accordance with generally accepted accounting principles applied on a basis consistent with that of the preceding year.


Chartered Accountants

Calgary, Canada
February 25, 1986

1. Accounting Policies

These financial statements are prepared on a historical cost basis in accordance with accounting principles generally accepted in Canada and conform in all material respects with the accounting standards recommended by the International Accounting Standards Committee.

(a) Oil and Gas Operations

The Company follows the "full cost" method of accounting for oil and gas operations whereby all costs of exploring for and developing oil and gas reserves, including the costs of production equipment, are capitalized and depleted using the unit of production method based on estimated proved oil and gas reserves (converted to equivalent units on the basis of estimated relative energy content).

In applying the full cost method, the capitalized costs less accumulated depletion and depreciation are limited to an amount equal to the estimated value of future net revenues from proved reserves (based on prices and operating costs in effect as at the balance sheet date) plus the lower of cost and estimated fair value of unproved properties.

(b) Joint Ventures

Substantially all the Company's exploration and development activities related to oil and gas are conducted jointly with others. The accounts reflect only the Company's proportionate interest in such activities.

(c) Deferred Financing Charges

Financing charges incurred in connection with the issuance of convertible debentures have been deferred and are being amortized on a straight line basis over ten years, the term of the debentures.

2. Other Assets

	1984	1985
Notes receivable from certain officers and employees, non-interest bearing, due from time to time to November, 1990	\$276,250	\$565,810
Deferred financing charges	200,659	176,089
	476,909	741,899
Less current portion of notes receivable	96,690	77,250
	\$380,219	\$664,649

3. Bank Production Loan

The bank production loan is evidenced by demand promissory notes, bears interest at the bank's prime lending rate and is secured by the Company's interest in certain oil and gas properties and a general assignment of accounts receivable.

The loan has been advanced under a revolving credit facility and no specific terms of payment have been established. The loan facility is reviewed annually and is to be paid out of future oil and gas production revenues.

4. 11% Convertible Debentures

The debentures bear interest at 11% per annum and are convertible into Common Shares of the Company at a price of \$10.25 per share to March 1, 1993, at which time any unconverted debentures become due and payable.

5. Capital Stock

(a) Authorized Capital

The authorized capital of the Company is comprised of 6,552 Restricted Return Shares, 10,000,000 Preferred Shares and 10,000,000 Common Shares.

(b) Restricted Return Shares

During 1985, the Company purchased and cancelled 128 Restricted Return Shares for \$3,840 cash. The difference (\$8,960) between the stated value of the shares and the purchase price has been credited to contributed surplus.

The holders of Restricted Return Shares have voting rights, limited dividend entitlements, and priority over Common shareholders in case of liquidation, dissolution or winding-up. The shares are redeemable under certain circumstances at the option of the Company at a redemption price of \$100 per share.

(c) Common Shares

Changes in the Company's outstanding Common Share capital during the year were as follows:

	Number of Shares	Amount
Balance, December 31, 1984	3,660,649	\$18,496,288
Shares issued		
For cash on exercise of employee share options	28,000	170,500
In exchange for exploration and development expenditures incurred by certain officers and employees, less accrued Petroleum Incentive Program payments of \$90,900	51,500	295,350
Balance, December 31, 1985	3,740,149	\$18,962,138

(d) No dividends may be paid on Common Shares until dividends aggregating \$100 per Restricted Return Share have been paid. Thereafter, dividends may be paid on Common Shares provided that an amount equal to any such dividends is applied to the redemption of Restricted Return Shares.

(e) Key Employee Incentive Share Option Plan

As of December 31, 1985, 360,000 Common Shares of the Company were reserved for issue under the Company's Key Employee Incentive Share Option Plan, of which options to purchase 237,000 shares are outstanding, exercisable from time to time to December 1991 at prices ranging from \$6.00 to \$8.25 per share.

(f) As of December 31, 1985, 721,951 Common Shares were reserved for issue on conversion of debentures (see note 4).

6. Income Taxes

Petroleum and natural gas properties include approximately \$7,000,000 of unamortized costs at December 31, 1985 which are not deductible for income tax purposes by the Company.

Deferred income tax provisions for 1985 and 1984 are less than the taxes which would result from applying the expected tax rate of 47% to earnings before income taxes. The components of the income tax provisions are summarized as follows:

	1984		1985	
	Amount	%	Amount	%
Computed expected tax expense	\$925,000	47	\$934,000	47
Increase (decrease) in taxes resulting from:				
Non-deductible crown charges, net of provincial credits	677,000	35	543,000	27
Depletion expense relating to non-deductible property costs	215,000	11	238,000	12
Federal resource allowance	(839,000)	(43)	(781,000)	(39)
Earned depletion allowance	(251,000)	(13)	(242,000)	(12)
Other	3,000	—	8,000	—
Actual deferred income tax expense	\$730,000	37	\$700,000	35

7. Subsequent Event

Subsequent to December 31, 1985, the Company acquired all the outstanding shares of Gallita Oils Limited, a Canadian private oil and gas company, for a net cost of \$5,500,000 which was financed by additional bank borrowings.

HISTORICAL FINANCIAL SUMMARY

(thousands of dollars except per share data)	1981	1982	1983	1984	1985
Revenue	\$ 650	\$ 3,519	\$ 5,166	\$ 7,326	\$ 7,641
Operating costs	211	587	803	775	949
General and administrative	337	472	639	675	728
Depletion and depreciation	237	642	1,041	2,016	2,576
Interest on long term debt	568	1,094	1,432	1,892	1,402
Earnings (loss) before income taxes	(703)	725	1,250	1,969	1,986
Deferred income taxes (reduction)	(47)	220	360	730	700
Net earnings (loss)	(656)	504	890	1,239	1,286
Cash flow from operations	(466)	1,366	2,312	4,010	4,889
Per common share:					
Net earnings	(.37)	—	.07	.42	.35
Cash flow	(.26)	.47	.79	1.35	1.33
Weighted average shares outstanding (thousands)	1,755	2,907	2,913	2,971	3,669
Capital expenditures	3,828	9,018	7,616	6,481	6,430
Total assets	18,575	23,760	31,033	36,030	40,662
Bank loans	3,500	8,500	7,000	4,100	5,700
Convertible debentures	—	—	7,400	7,400	7,400
Deferred taxes	—	220	580	1,147	2,150
Total shareholders' equity	13,129	13,614	14,574	21,680	23,428





ONYX PETROLEUM EXPLORATION COMPANY LTD.